India

In need of investment

Economic activity slowed sharply in the first quarter of fiscal year 2019/2020 and second-half prospects are looking morose, even though the monetary authorities and the government have taken major stimulus measures. Monetary easing resulted in a mild decline in lending rates. The recently announced cut in the corporate tax rate should boost domestic and foreign investment in the medium term, although it will not impact growth much in the short term. Companies might decide to consolidate their position rather than to invest in the midst of a sluggish environment.

Economic growth slumps to record lows

India's GDP growth has slowed sharply since the second half of 2018. In the first quarter of fiscal year 2019/2020 (from April to June 2019), GDP rose only 5% year-on-year (y/y), the slowest pace in the past six years. The slowdown is mainly due to the sharp deceleration of domestic demand. Although Indian exports slowed (while exports from the other Asian countries contracted), the net contribution of exports swung into positive territory after making a negative contribution for the previous eight quarters.

Private consumption, the main growth engine, rose by only 3.1% y/y compared to a 2018 average of more than 8%. The slowdown can be attributed to a decline in household confidence combined with an increase in the unemployment rate, which rose to 8.2% in late August (vs. 6.5% in the year-earlier period). Moreover, the supply of non-bank lending slowed due to the financing difficulties encountered by non-banking financing companies (since the bankruptcy of IL&FS in September 2018). Total investment slowed sharply to 4% y/y (vs. 13.3% last year) at a time of high interest rates (9.8% for new rupee-denominated loans in July) even though the Reserve Bank of India (RBI) has been easing monetary policy since February 2019. Average interest rates on new loan production declined by only 29 basis points (bp) between February and August, despite the central bank's 110bp key rate cut over the same period.

Economic indicators for the second quarter of the current fiscal year do not suggest a rebound in the short term. Output of capital goods contracted in August for the seventh consecutive month, automobile sales declined sharply, confidence surveys continued to deteriorate and industrial activity, according to the latest PMI surveys, still did not rebound in August. Lastly, bank lending has been slowing since February and slumped even further in August.

The government and the central bank have undertaken numerous measures to boost economic activity, the biggest of which was the sharp cut in the corporate tax rate.

Corporate tax cut: a positive medium-term impact

In late September, the government announced that it was cutting the corporate tax rate from 30% to 22% (effective retroactively to 1 April 2019), with a preferential rate of only 15% for manufacturing companies created after 1 October 2019. Including all of the other taxes companies must pay (notably education taxes), this would bring the effective tax rate to 25.17% (17% for new manufacturing companies), which is close to the corporate tax rates applied in the other emerging markets of Asia (25% in Indonesia, 24% in Malaysia).

In the short term, the impact of the corporate tax cut is bound to be limited. The current slowdown is essentially due to household consumption. Moreover, Indian companies might decide to use the tax cut to slash debt rather than to invest in the midst of a sluggish economic environment.

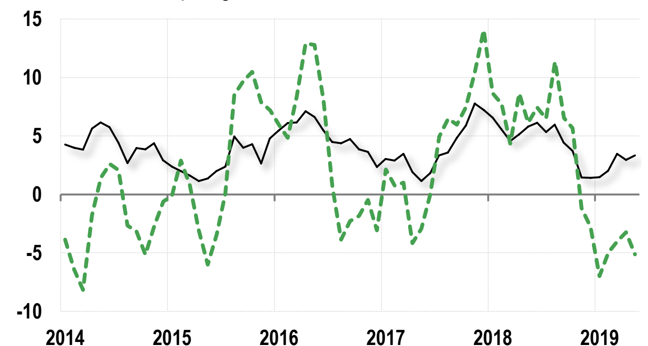
1-Forecasts

	2017	2018e	2019e	2020e
Real GDP growth[1] (%)	7.2	6.8	5.4	6.5
Inflation [1] (CPI, year average, %)	3.6	3.4	3.5	3.8
Central Gov. Balance[1] / GDP (%)	-3.5	-3.4	-3.6	-3.4
Central Gov. Debt[1]/ GDP (%)	45.6	44.6	44.4	44.1
Current account balance[1] / GDP (%)	-1.8	-2.1	-2.1	-2.2
External debt[1]/ GDP (%)	20.0	20.0	19.9	20.0
Forex reserves (USD bn)	409	393	435	460
Forex reserves, in months of imports	11.5	9.1	9.4	9.3
Exchange rate USDINR (year end)	63.9	71.0	71.2	73.5

(1): Fiscal year from April 1st of year n to March 31st of year n+1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Industrial output



Source: CEIC

In the medium term, this measure should increase India's competitiveness, thereby favouring foreign direct investment (FDI). Yet the Modi government must take its reform efforts further. Restrictions on land acquisition and labour market rigidity continue to place a major damper on domestic and foreign investment.

Public finances: risk of fiscal slippage in 2019/2020

For the second consecutive year, the federal government may not meet its target of reducing the fiscal deficit to 3.3% of GDP in fiscal year 2019/2020 (compared to 3.4% of GDP in 2018/2019). In the first 5 months of the fiscal year, the fiscal deficit was already equivalent to 78.7% of its full-year target.

This poor performance can be blamed on revenues, which fell far short of estimates. In the first 5 months of the current fiscal year, spending amounted to 42.2% of the full-year target, but revenues – though on the rise – accounted for just 29.8% of the full-year target of 9.9% of GDP (vs. 8.8% of GDP in 2018/19). Taxes revenue was the main component that fell short of the government's forecast. It amounted to only 24.5% of the full-year target due to the downturn in domestic demand and foreign trade.

According to government estimates, the cut in the corporate tax rate will generate a revenue shortfall of 0.7% of GDP (including 0.46% of GDP for the central government). Part of this shortfall will be offset by a bigger-than-expected transfer of the central bank's surplus: in late August RBI announced that the transfer of "capital surplus" (in relation to its needs) to the government would be equivalent to 0.8% of GDP (vs. 0.5% of GDP in the finance ministry's initial fiscal forecast). If the government does not significantly reduce spending during the rest of the year, the deficit for the general government could increase by 0.4 pp to 6.7% of GDP. Consequently, the government seems to be very far from meeting its target of reducing the public debt ratio to 60% of GDP by 2025 (from 67.3% of GDP in 2018/2019).

For an emerging country, India's public debt is still high[1] although its structure is not very risky. Exchange rate risk is low because debt denominated in foreign currency accounted for only 2.8% of GDP in June 2019. Refinancing risk is also limited since the average maturity on the debt is 10.4 years. Only 4.3% of its debt will reach maturity over the next twelve months. With residents holding 93% of its debt, the government is not very dependent on foreign investors for debt financing.

Less pressure on external accounts

India's external accounts deteriorated in 2018. A wider current account deficit combined with a decline in foreign direct investment and portfolio investment resulted in a USD 15 billion decline in foreign exchange reserves and a 9% depreciation of the rupee against the dollar.

This movement has since been reversed. In the first 9 months of 2019, the average exchange rate has been stable and foreign exchange reserves have increased by USD 33.5 billion to a record high of USD 401.6 billion at the end of September. Reserves cover 1.4 times the country's short-term financing needs (USD 297 billion). At the same time, FDI and portfolio investment have increased (to 1.9% of GDP and 1.4% of GDP, respectively, in H1 2019). The big increase in FDI following the re-election of N. Modi is particularly good news, because 1) it covers the current account deficit, and 2) it reduces the country's dependence on volatile capital inflows. Although the current account deficit is likely to widen in the second half of 2019 (after reaching 1.3% of GDP in H1 2019, compared to 2% in the year-earlier period) it should continue to hold at about 2.5% of GDP.

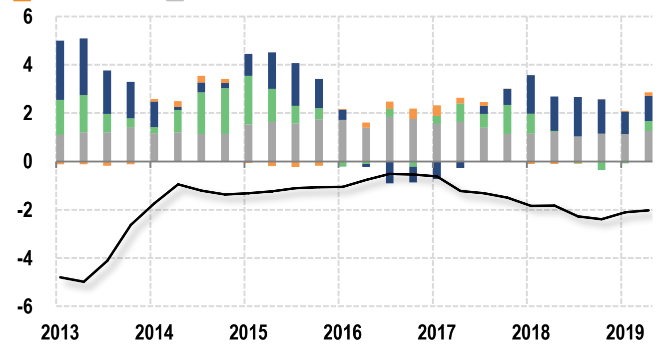
3 – Balance of payments

4-quarter sum, of GDP

— Current account balance

Net portfolio investment | Net other investment

Net derivatives | Net direct investment



Source: RBI

Lastly, external debt is still mild, although it has increased slightly (+8.7 in Q2 2019 y/y). At the end of June 2019, it amounted to only 19.8% of GDP. Commercial borrowing is the largest debt category (38.4% of the total), followed by non-resident deposits (24%) and short-term trade credit (18.7%).

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[1] In comparison, Indonesia's government debt accounted for only 30.1% of GDP in 2018.